

Internal Revenue Service

**memorandum**

CC:TL:TS/P&SI  
JCGIBBONS/lmr

date: OCT 3 1991

to: District Counsel, Louisville CC:LOU  
Attn: Jennifer A Decker, Senior Attorney

from: Chief, Passthroughs and Special Industries CC:FS:P&SI

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subject: Application of the Duty of Consistency in  
[REDACTED] v. Commissioner,  
Docket No. [REDACTED]  
TL-N-8352-91  
Gibbons Sabin

This is in reply to your Tax Litigation Advice request of July 3, 1991.

ISSUES

- (1) Whether, in the instant case you should follow the reasoning of the Tax Court in Erickson v. Commissioner, T.C. Memo. 1991-97, and not attempt to recoup lost tax through the application of the duty of consistency doctrine.
- (2) Whether, on the basis of Erickson, you should discontinue the use of the duty of consistency doctrine in settlements or in litigation that involve a year barred by the period of limitations.
- (3) Whether you should settle with taxpayers, whose fact situations are similar to the instant case on the same basis even if they are willing to agree to recoupment.

CONCLUSIONS

- (1) Erickson governs the instant case. Accordingly, recoupment of barred tax through the application of the duty of consistency is not appropriate and would not be permitted by the Tax Court.
- (2) The duty of consistency doctrine should not be generally abandoned on the basis of Erickson. Erickson, which held that the taxpayer was not bound by a duty of consistency, is a fact driven determination turning on the Commissioner's reliance upon information provided by the taxpayer.

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(3) Similarly situated taxpayers should receive the same settlement offer.

#### FACTS

The instant case arises from petitioners' investment, through the [REDACTED], in United States Government Securities in [REDACTED], [REDACTED], and [REDACTED]. Basically, the petitioners, through [REDACTED], engaged in straddles for all three years using Treasury Notes. For [REDACTED], petitioners claimed flow-through deductions under I.R.C. § 212. Specifically, the petitioners claimed Schedule A deductions of \$[REDACTED] for coupon equivalent payments on the Treasury Notes and \$[REDACTED] for other investment expenses incurred in the straddle transactions. For [REDACTED], the petitioners claimed interest and investment expenses related to their straddle activities, but they also reported a flow through short term capital gain and interest income. For [REDACTED], the petitioners claimed interest and investment expenses related to their straddle activities, but they also reported flow through long-term capital gain and interest income. [REDACTED] is barred by the statute of limitations; [REDACTED] and [REDACTED] are docketed years. Although the petitioners received a statutory notice disallowing the [REDACTED] Schedule A deductions described above, that notice was found to be invalid by the Tax Court because it was misaddressed.

The Service maintains that the subject transactions were shams or were not entered into for profit. The statutory notices issued with respect to [REDACTED] and [REDACTED] disallow the deductions claimed relative to petitioners' interest in [REDACTED]; however, none of the income attributable to [REDACTED] was removed in those notices.

At present, the petitioners and the respondent are attempting to reach an agreement on the substantive issues in this case. The assigned Appeals Officer sent settlement computations to the petitioners. The Appeals Officer computed the petitioners' tax liability for each of the taxable years [REDACTED], [REDACTED], and [REDACTED] pursuant to the national settlement offer governing [REDACTED] investments which allows an out-of-pocket deduction for [REDACTED] and removes all income and deductions from [REDACTED] in each of the taxable years. However, to recoup the resulting deficiency for [REDACTED], which is now barred, the Appeals Officer increased the deficiency for [REDACTED] by the amount barred, adjusted to account for the lost interest.

The petitioners rejected the settlement, asserting that the Service can not recoup the tax lost from [REDACTED] due to [REDACTED] items which were never adjusted in a valid statutory notice. Petitioners nevertheless contend that in the years before the court, the respondent should remove all the income reported in connection with [REDACTED], because the transactions underlying that income were shams.

Invoking the "duty of consistency" doctrine, the Appeals Officer contends that, unless the petitioners accept the Government's settlement offer, they should not be allowed to remove the income they reported from [REDACTED] for [REDACTED]. Because the petitioners deducted losses in [REDACTED], a barred year, the Appeals Officer maintains that the petitioners can not be allowed to benefit by admitting for the taxable years [REDACTED] and [REDACTED] that the [REDACTED] transactions were shams.

You further relate that you have several other straddle cases in which the loss year is barred but the gain years are docketed. In each of these other cases, the taxpayers contend that their gain should be removed from the open years because the underlying transactions were shams. The taxpayers in each of these cases, however, object to the repayment of the barred deficiency attributable to the same transaction. With respect to this group of cases, you frequently do not know why a particular year has become barred. While, in a given case, you may know that the statute of limitations for one of the three relevant years has expired, you may not have sufficient information available to determine whether, as was the case in Erickson, the Service knew or had reason to know of erroneous deductions prior to the expiration of the statutory period.

In several of your cases with facts similar to the present case, the petitioner has indicated a desire to settle, accepting recoupment of barred assessments. You have not alerted any of these petitioners to the Erickson case. You intend to take no action in the present case or in any similar case until we advise you how to proceed.

The cases which are the subject of your inquiry are appealable to the 9th Circuit.

#### Discussion

The courts have consistently held that a taxpayer cannot in a subsequent year treat items in a manner inconsistent with his treatment of the item in a barred year. In Unvert v. Commissioner, 72 T.C. 807 (1979), aff'd on other grounds, 656 F.2d 483 (9th Cir. 1981), the Tax Court summarized the rule as follows:

Because "it is no more right to allow a party to blow hot and cold as suits his interest in tax matters than in other relationships," courts have held a taxpayer to a duty of consistency in his tax treatment of related items. Alamo National Bank v. Commissioner, 95 F.2d 622, 623 (5th Cir. 1938), aff'g 36 B.T.A. 402 (1937), cert. denied, 304 U.S. 577 (1938). The duty of consistency precludes a taxpayer who has received a tax benefit due to his treatment of an item in a year barred by the statute of limitations from claiming that the original treatment was incorrect and thus obtaining a tax advantage in a later year.

The doctrine of duty of consistency applies where the taxpayer adopts a position, realizes a tax advantage and subsequently attempts to adopt an inconsistent position regarding the same transaction in order to gain another tax advantage. Application of the rule is not dependent on the happening of a "fundamentally inconsistent event" as is the case with the tax benefit rule. Rather, the rule is applied whenever the taxpayer changes his position on a transaction. The rule imposes on the taxpayer a duty to maintain a consistent position regarding all tax aspects of the transaction.

In Beltzer v. United States, 495 F.2d 211 (8th Cir. 1974), the court outlined the prerequisites for application of the doctrine, as follows:

- (1) The taxpayer must make a representation or report an item for tax purposes in one year;
- (2) the Commissioner has acquiesced in or relied on that fact for that year; and
- (3) the taxpayer desires to change the representation, previously made, in a later year after the statute of limitations on assessment bars adjustments for the initial year.

In Erickson the Government alleged that the duty of consistency required the petitioner to include gains in income in 1982 that were attributable to admittedly sham transactions in certain shelters because the petitioner deducted losses in 1980, a closed year, with respect to similar transactions. The Tax Court analyzed the facts in this case under the three prong test set forth in Beltzer, supra. The court found that the second prong of the Beltzer test, which requires that the Commissioner must have acquiesced in or relied upon a report or representation made by the taxpayer in an earlier year, had not been met. It based its conclusions on the fact that the Commissioner had

possessed sufficient information prior to the expiration of the 1980 statute of limitations to place him on notice that during 1980 the taxpayer was involved in the particular shelter and that any deductions taken by the taxpayer with respect thereto were improper.

Thus, Erickson is a fact oriented analysis as to whether the Commissioner's reliance on the taxpayer's representation is justified. Facts which the court found in aggregate to be inconsistent with justifiable reliance include:

- (1) demonstrable suspicion on the part of the Commissioner's agent prior to the running of the period of limitations that the now barred year involved the same transaction;
- (2) inquiry by the agent with respect to the now barred year; and
- (3) a taxpayer who was responsive to the agent's inquiry and who did not make any misrepresentations.

The concept that the Commissioner has not relied on a taxpayer's representation if he knows or has reason to know of taxpayer errors or omissions and that he may not, therefore, demand consistency with a now barred year did not originate in Erickson. See The Pennsylvania Company for Banking & Trusts v. United States, 51-2 U.S.T.C. 9392 (E.D.Pa. 1951), which involved the taxability of an exchange made in 1930.

Because questions regarding the Commissioner's reliance are fact driven, different facts produce a different result. In Unvert, the Tax Court considered whether money paid toward the purchase of a condominium in 1969 and improperly deducted as interest in that year must be treated as income when recovered in 1972. In Unvert, 1969, was a barred year. The Tax Court proposed two theories under which the recovered payment must be included as income when recovered in 1972. The first theory was the tax benefit rule, although the Court struggled to distinguish the Unvert facts from earlier cases wherein it stated that the tax benefit rule does not apply if the actual deduction was

improper.<sup>1/</sup> The second theory proposed by the Court that required inclusion was the duty of consistency doctrine. In addressing the duty of consistency, the court indicated that the application of the doctrine to the taxpayer depends on the availability of the true facts to the Commissioner during the period before the statute of limitations expired. In this regard, the court placed considerable emphasis on the fact that, during the Unvert audit and at a time when 1969 was still an open year, the taxpayer through his accountant resisted the inquiries of the Commissioner's agent and engaged in a "wrongful and misleading silence."

As indicated earlier, the Ninth Circuit Court of Appeals (the court to which your cases are appealable) affirmed Unvert by rejecting the erroneous deduction exception to the tax benefit rule. That court did not review the Tax Court's application of the duty of consistency doctrine. It did, however, in footnote 2 acknowledge the existence of the doctrine by suggesting that cases decided under the duty of consistency doctrine "involve courts in more complex case-by-case adjudication." This statement lends credence to our belief that duty of consistency doctrine cases are fact bound, particularly as they relate to the questions of the Commissioner's reliance.

With respect to the subject case, the facts indicate that the Commissioner thoroughly examined the [REDACTED] tax year prior to the passage of the period of limitations. This is evidenced by the Commissioner's issuance of a timely statutory notice that was found invalid because it was misaddressed. Under these

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<sup>1/</sup> The Tax Court has consistently held that if a deduction was initially improper, the tax benefit rule does not apply. If the period prescribed by the statute of limitations expires, the Service cannot include in income an amount equal to the previous improper deductions even if there is a recovery of the deducted amount or the occurrence of an event which is fundamentally inconsistent with the deduction. This is commonly referred to as the erroneous deduction exception to the tax benefit rule. See Southern Pacific Transportation Co. v. Commissioner, 75 T.C. 497, 559 (1980); Kingsbury v. Commissioner, 65 T.C. 1068, 1087-1088 (1976); Mayfair Minerals Inc. v. Commissioner, 56 T.C. 82, 87-88 (1971), aff'd per curiam 456 F.2d 622 (5th Cir. (1972)); Canelo v. Commissioner, 53 T.C. 217, 226 (1969) aff'd on other grounds 447 F.2d 484 (9th Cir. 1971) issue not raised in taxpayer's appeal; Streckfus Steamers, Inc. v. Commissioner, 19 T.C. 1, 8 (1952).

circumstances, it is unlikely that the Tax Court would hold the taxpayer to a duty of consistency with respect to open years. In short, the facts indicate that the Commissioner knew or had reason to know of the erroneous deductions prior to the expiration of the statutory period.

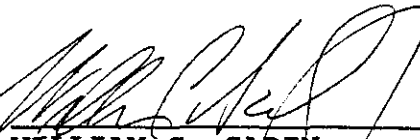
We do not believe, however, that Erickson stands for the proposition that the Commissioner should abandon use of the duty of consistency concept in the settlement process or in litigation. As discussed above, we believe that the application of duty of consistency is fact driven, particularly as it relates to the element of the Commissioner's reliance. Accordingly, Erickson should not be viewed as a basis for conceding cases that are on their face distinguishable or that with factual development can be distinguished.

On the other hand, those taxpayers whose facts are indistinguishable from the instant case should receive the same offer even if they are amenable to recoupment. This is because of the policy that similarly situated taxpayers should be treated the same. Nothing herein should be construed however to suggest what you should offer to settle with the instant taxpayer and those similarly situated. Rather, it is only to say that in measuring the hazards of litigation here, you should realize that the duty of consistency doctrine is not available.

Further questions in this matter may be directed to Jim Gibbons. His FTS number is 566-3233.

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